

THE ECONOMIC SITUATION

Bruce Yandle

Dean Emeritus,

College of Business & Behavioral Science, Clemson University

Distinguished Adjunct Professor of Economics, Mercatus Center, George Mason University

yandle@bellsouth.net

Note: Cartoonist Robert Aial generously allows his cartoons to be used in the Economic Situation report. To add your name to the report email list, please send an email: economic_situation-l-subscribe@strom.clemson.edu

December 2011

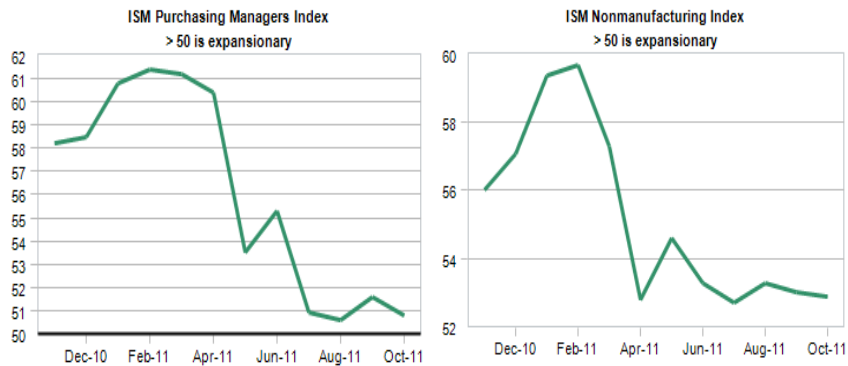
- **Checking the economy's pulse rate.**
 - **What about next year?**
 - **Growth? Where's the beef?**
 - **People: The right stuff.**
 - **Stimulus and where people work.**
 - **What about oil?**
 - **No man is an island.**
-

Time to take the Pulse

With 2012 just around the corner, it's time to visit intensive care and check on the 2011 economy. It's been a rough year. We began with 9% unemployment in January and seem to be ending with the same stubborn number. The patient has not responded to stimulus. In fact, Mr. Obama's OMB doctors say we should learn to live with it. Nine percent seems to be new equilibrium. While the unemployment rate seems frozen in place, so it is with the Dow Jones. We move into December with January's number.

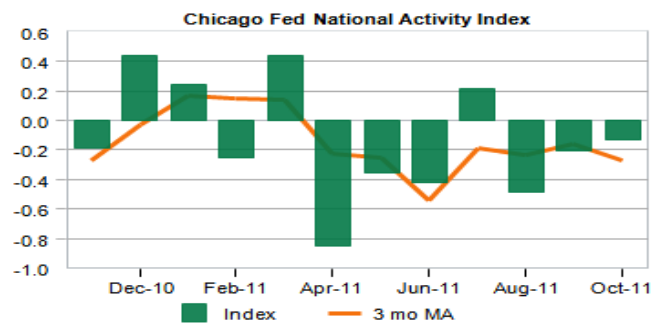
When we check the charts more closely, we discover a whole lot of shaking going on. Consider the accompanying Institute of Supply Management's (ISM's) indexes for the manufacturing and services economies. Recall 50 is the neutral point where the economy is dead in the water. A value greater than 50 signals growth. Up to this point, the indexes have performed the equivalent of an economic swoon. Earthquakes in Japan, hurricanes and floods in the U.S., credit agency downgrades of U.S. debt, Washington Keystone Cops political rhetoric, and European economic tremors have taken their toll. No, we haven't crossed the dreaded 50 and entered recession territory, but we are surely close. (And for the record, I'm betting the U.S. will not experience a recession any time soon, as in 2012).

TWO KEY U.S. INDICATORS



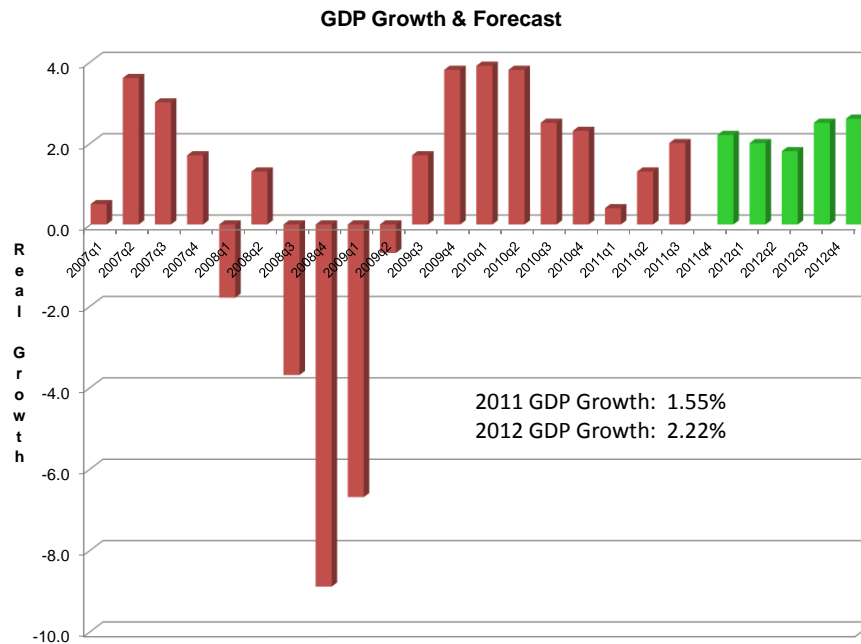
Through November 2011

The Chicago Fed's national economic activity index gives a similar reading. By their reckoning, a value of minus 0.07 identifies the start of the dead zone. Anything larger is a sign of life. As seen in the next chart, things are weak, but not that weak. It is much too early to call the undertaker. The bell does not toll for thee, quite yet.



What about next year?

When all this and more gets put in the GDP pot and stirred, we see the next chart, which also includes some 2012 projections.



Of course, the actual growth numbers for the next five quarters will not likely be as neat and orderly as the green bars in the chart, but the general shape of the path displayed is what I expect to see, based on what we know now.

GDP forecasts by various soothsayers have generally followed the decaying pattern of the ISM indexes shown earlier, which is to say the older the forecasts in terms of this year's calendar, the better they look. I show next a small sample of dated forecasts along with my current assessment, which is labeled Economic Sit.

GDP Forecasts

	Date	2011	2012
Blue Chip	11/2011	1.7%	2.0%
CBO	08/2011	2.3%	2.7%
Economy.com	11/2011	1.8%	2.6%
Economic Sit	12/2011	1.5%	2.2%
Merrill	08/2011	2.8%	2.9%
OMB	09/2011	1.7%	2.6%
Wells Fargo	11/2011	1.8%	2.0%
World Bank	01/2011	2.6%	2.9%

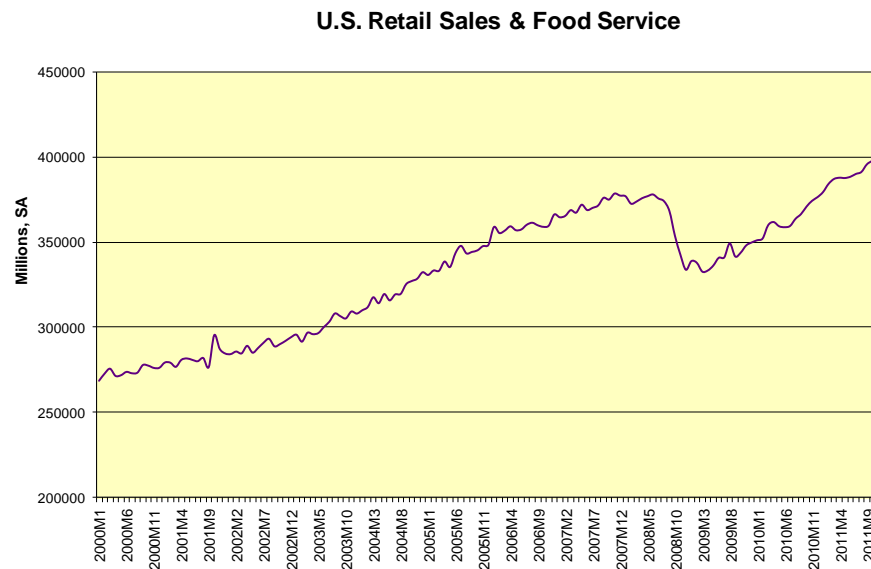
Where's the beef in the economy?

So where will the growth come from? Where's the beef?

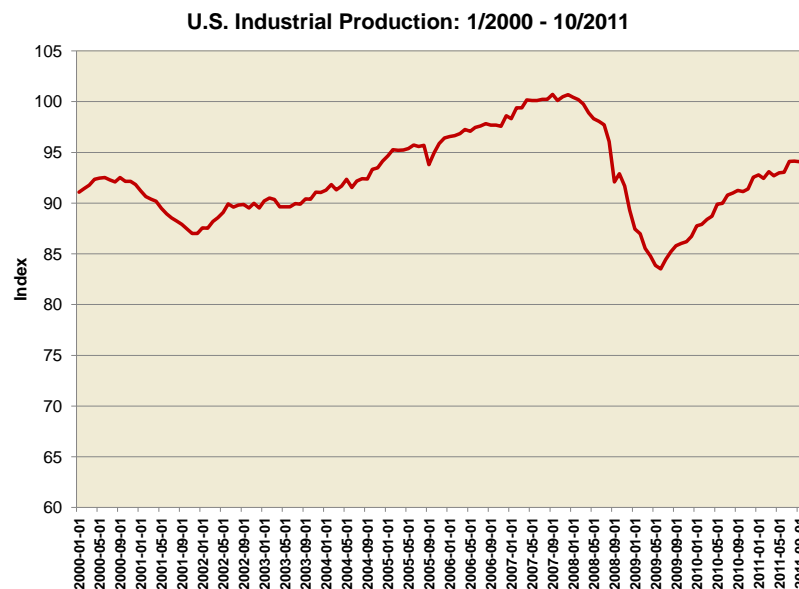
We must regularly remind ourselves that by conventional measures, an economy with 9% unemployment is an economy with 91% employment. Yes, I understand the solid estimates regarding discouraged workers, hard-pressed individuals who hold down part-time jobs while looking for more and other rich interpretations of unemployment. Those interpretations help us to understand the tough parts of a recession-driven slow economy. But I also know that 9% unemployment, as bad as it is, still leaves a large economic engine running.

Where's the evidence?

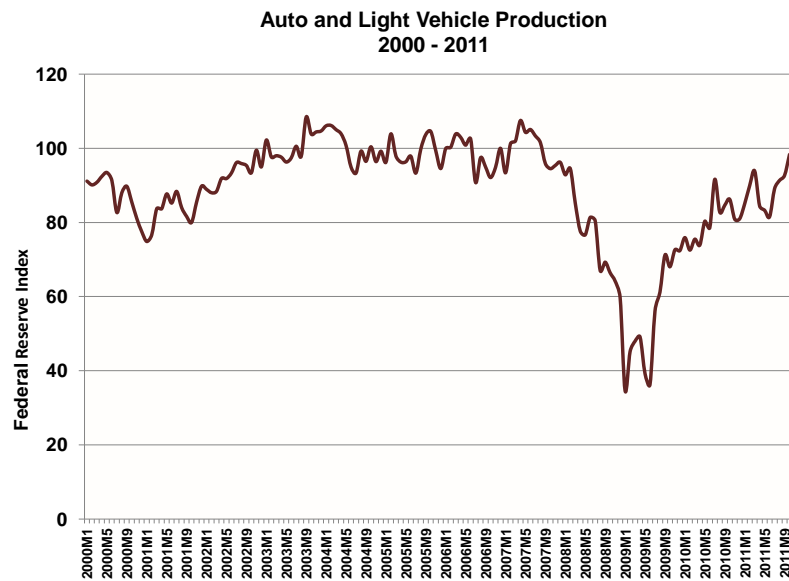
Consider the turnaround in retail sales. As shown in the next chart, America is shopping again. Expenditures on retail items and food service have more than recovered. Sales are well above pre-recession levels. Consumers are apparently acting with greater confidence. Some of the earlier fear evidenced in high savings rates may have subsided.



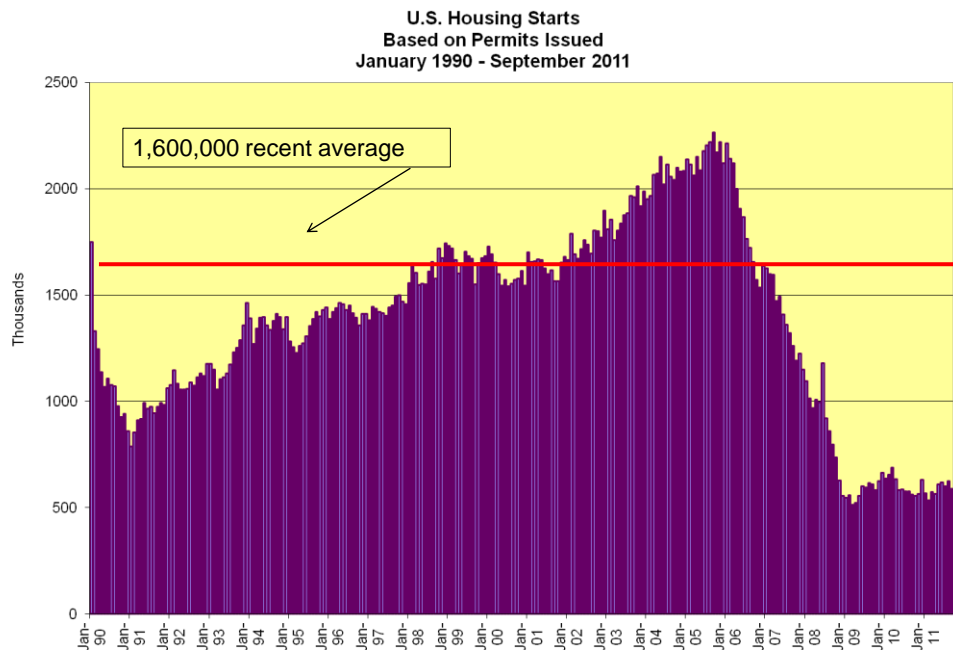
To sell more, more goods have to be produced...somewhere. Not all of it comes from China. We see this in Federal Reserve production data for the U.S. economy shown next.



As can be seen, overall U.S. production is about two-thirds recovered to the pre-recession level. Production of autos and light vehicles gives an even brighter picture.

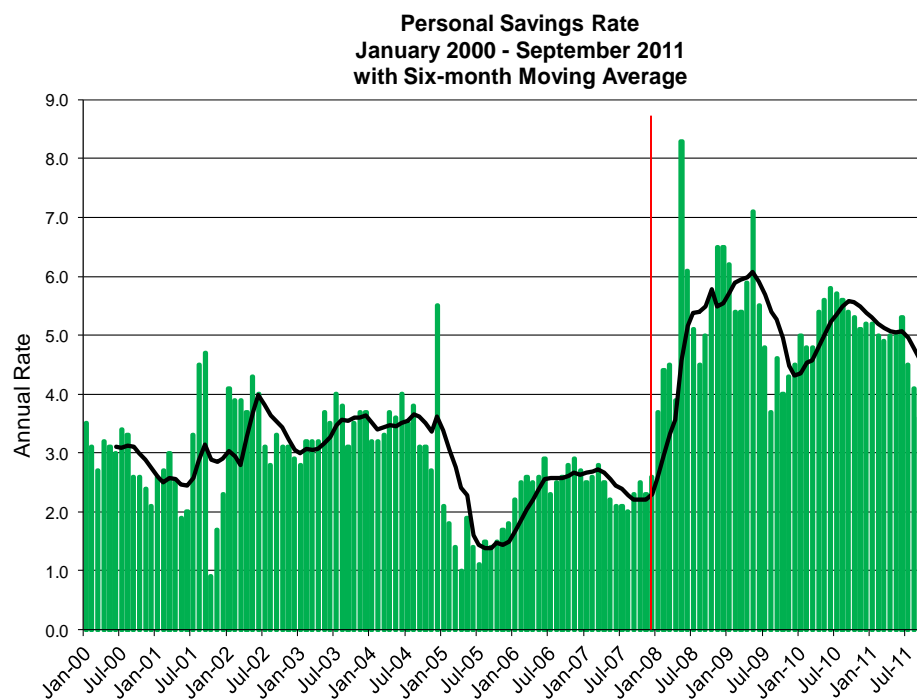


Of course, housing construction—the sleeping economic engine—is, yes, still asleep, as shown here in terms of housing permits.



And what about savings?

Personal savings data tell us consumers have surely gotten more comfortable with their improved balance sheets. As shown here, savings spiked following the financial crisis, which is marked by a red vertical line, but has fallen somewhat in recent months. Along the way, a lot of credit card debt was cleared away.



The Super Committee and too much turkey?

Europe trembled. Heads of state in Italy and Greece joined the unemployed. The Dow gave up the gains for 2011. But unimpressed, the U.S. deficit Super Committee stood by the principles of its members and did nothing.

Cartoonist Robert Arian captured the feelings of many Americans with his interpretation of the committee's inability to offer even a small slice of pre-Thanksgiving fiscal sanity to sick-of-politics-as-usual electorate. Instead of sanity, we got too much turkey. This left the nation's purse partly on automatic pilot, at least in theory. Somewhere out there in 2013, we may experience the discomfort of a decade of budget cuts that will average \$120 billion each year, split evenly between defense and discretionary spending. Medicare, Medicaid, Social Security and other entitlement spending will not be affected. Unfortunately, getting our house in order will require even more pain.



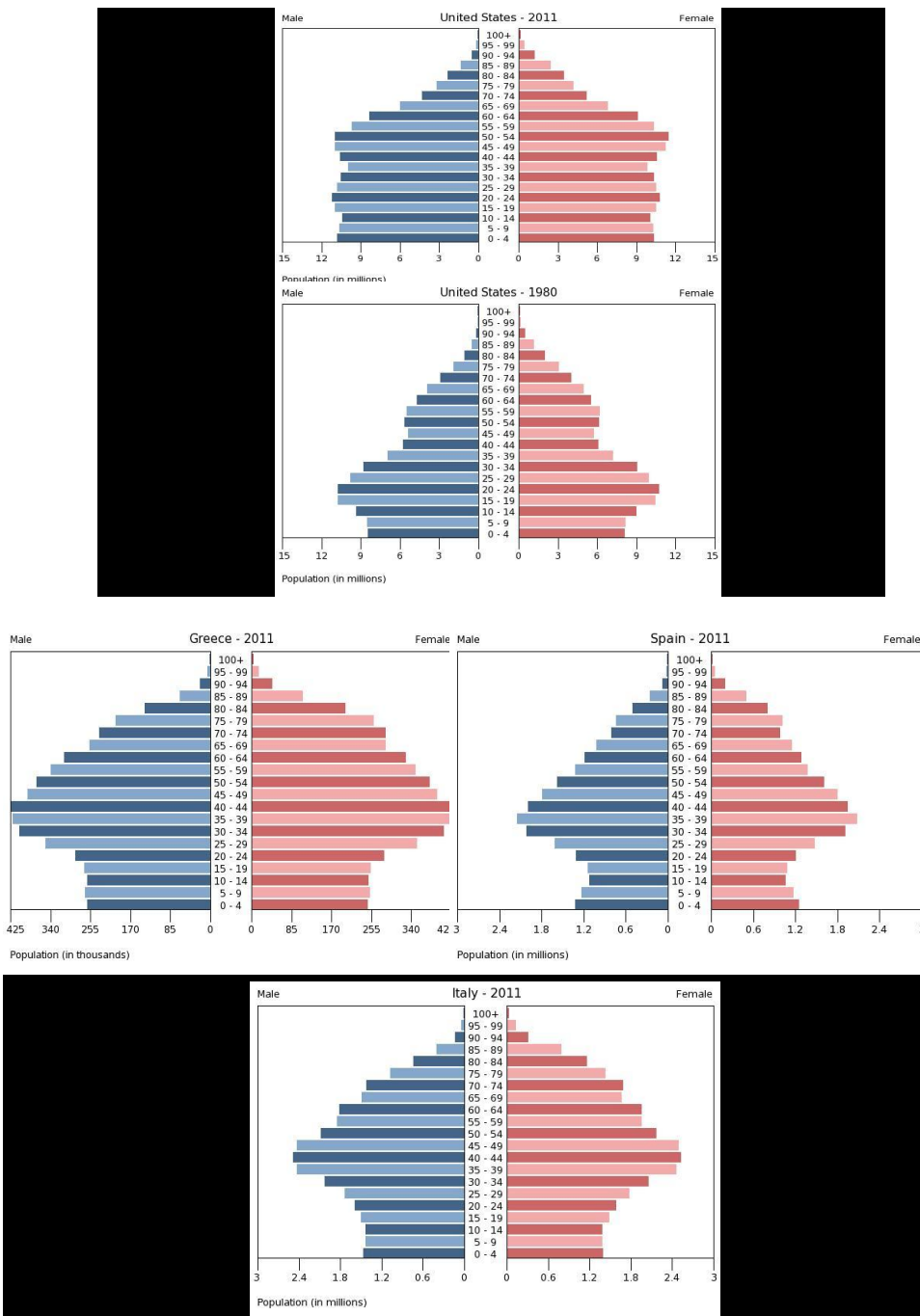
Now, \$120 billion is real money, even in Washington. For example, the Department of Defense 2012 budget request is \$670 billion. EPA asks for \$8.9 billion. Education requests \$69.9 billion, and Interior, \$12.2 billion. But let's face it, Congress has never before allowed statutory spending limits to limit spending. Maybe this time will be different. But don't bet on it. In addition to the usual forces that push for more spending for me and taxing thee, there is an election in the works, which adds a bit more uncertainty.

What we observe taking place in other countries, in U.S. states, counties and cities predicts what cannot be avoided at the federal level. Big cuts in spending are part of the solution. Tax reform is another part. But no matter how the budget is sliced and diced, work by Duquesne economist Antony Davies tells us there is only so much revenue the federal government can pull into the coffers. His examination of OMB data from 1954 to the present indicates 18.5% of GDP is the expected yield, no matter what the marginal tax rate. We are currently spending 25.3% of GDP, with 23.6% expected in 2012, and better than 22% through 2016. Raising taxes in the hope that 23% to 22% of GDP will follow is not apt to work. When the rates go up on ordinary people or millionaires, the smart folks find a way to avoid taxes. It pays them to do so.

People: The Right Stuff

It may be darkest before dawn, so it helps to find a few rays of light when staring at the budget mess. After all, some future population will have to pay off our debt and pay for future spending. A healthy future workforce will help. Fortunately, the United States looks a lot better than other debt-loving nations. Thinking in terms of age distribution, it will help to have more work age people than retired folk.

Consider the next few population pyramid charts. The first compares the U.S. for 2011 and 1980. Thanks to immigration, we are a younger country today, with a growing work-age population. The U.S. chart is followed by one that compares Greece, Italy, and Spain. Obviously, age distribution matters when it comes to paying off debt.

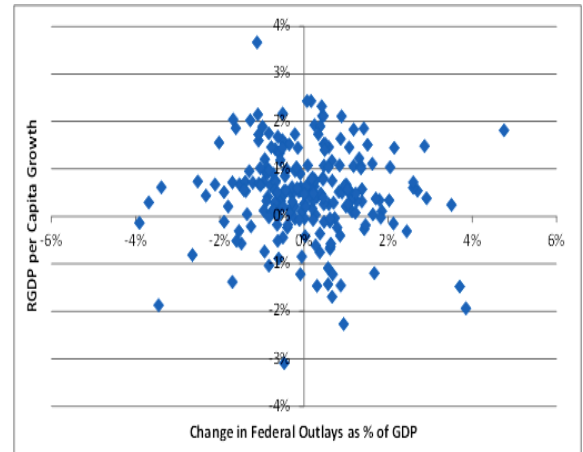


Stimulus, where we work and how we live

In discussing taxes and revenues, I mentioned work by Duquesne University economist Antony Davies. Antony has taken a close look at the relationship between increased federal spending and GDP growth. Some economic advisors believe the federal government can stimulate GDP growth by spending more money. Others deny the possibilities. Still others aren't sure either way.

Put simply, what happens when government spends to stimulate is an empirical matter.

Davies mapped quarterly government spending increases into real per capita GDP growth for the current period and one year later for data covering 57 years, from 1954 to 2011. A positive systematic relationship would result in an array of points that drifts from the southwest toward the northwest corner of a chart. I provide Davies' result for same period effects. The lagged relationship looks the same.



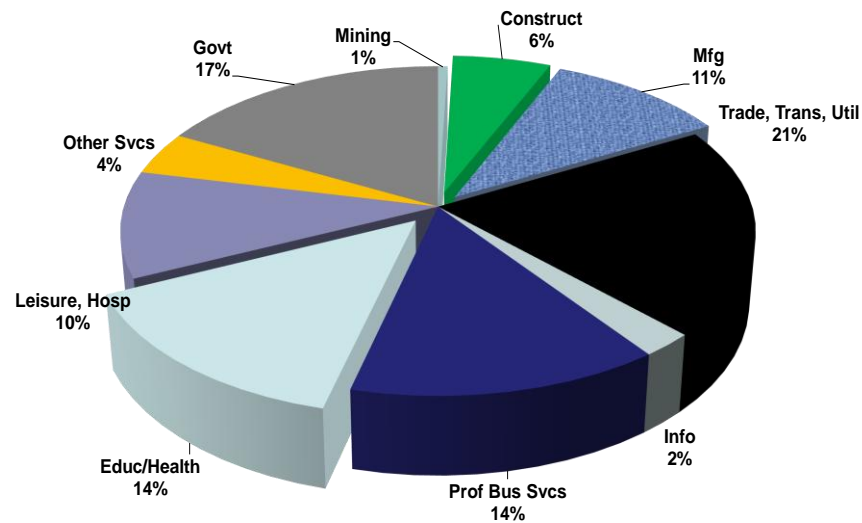
Data source: Bureau of Economic Analysis, National Income and Product Accounts

DUQUESNE UNIVERSITY Antony Davies, Ph.D.
www.antonydavies.org

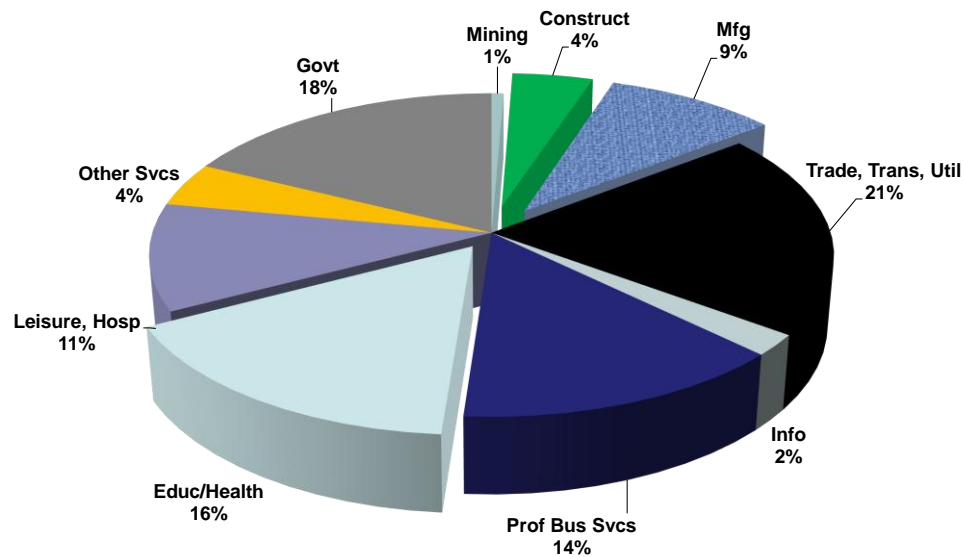
There is no evidence here that stimulus spending leads systematically to higher per capita GDP growth.

Well if stimulus can't help everyone taken together, can it help some? If government targets stimulus spending to favored sectors, is there evidence that labor markets are affected? The Obama administration stimulus focused heavily on the education and health sector. Other than auto industry bailouts and subsidies to clean energy producers, manufacturing was not favored. I provide two pie charts that show where people work in America. One chart is for 2007; the other is for 2011.

U.S. Employment Sectors, Oct. 2007



U.S. Employment Sectors, Oct. 2011



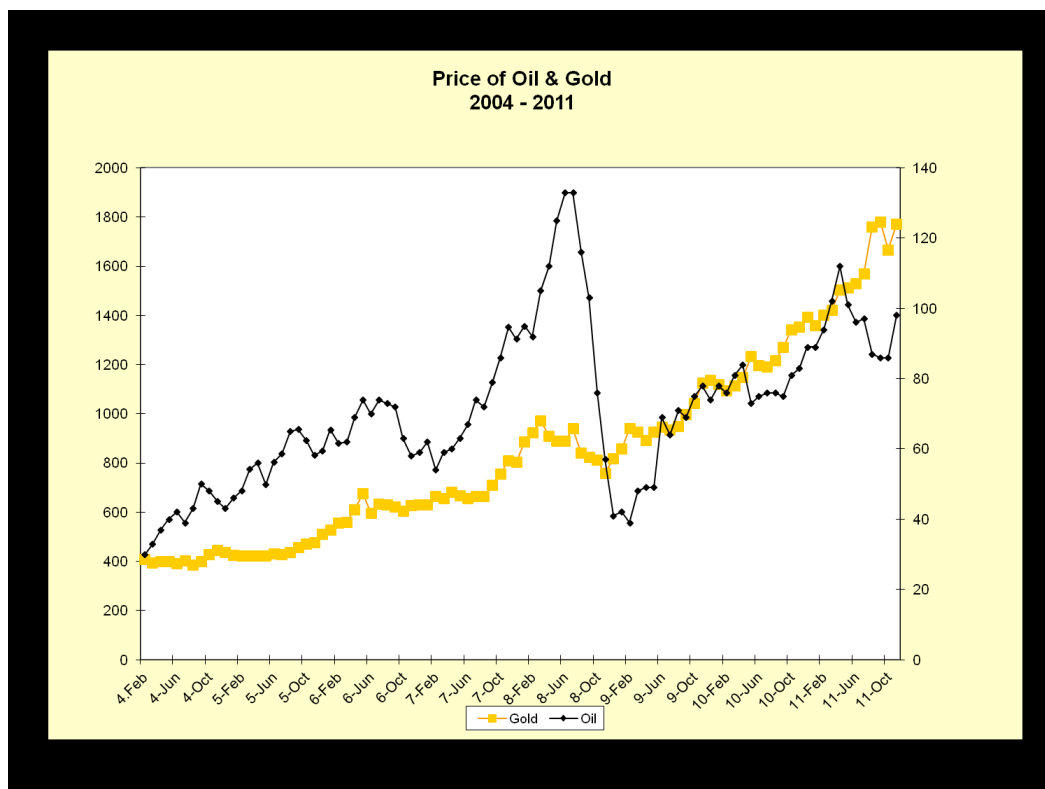
Close examination reveals that the health/education sector's employment share has risen from 14% in 2007 to 16% in 2011. Manufacturing's share has fallen from 11% to 9%. Also, construction's share is down, and government is up.

Generally speaking, women dominate employment in education and health. Men dominate manufacturing employment. As it turns out, the relative position of female workers has improved somewhat. The unemployment rate for women in October 2011 was 8.5%. For men, 9.5%. In October 2007, before the onset of the recession, the female unemployment rate was 4.6%. For men, 4.9%. The female improvement may explain partly a small gain in median female earnings. Stated in 1982/84 dollars, female median earnings in 3Q2007 was \$298. In 3Q2011, \$301. Up \$3.00. For the same periods, the male median earning was \$372 in 2007 and \$369 in 2011. Down \$3.00.

What about oil?

In recent reports, I have shown the relationship between the prices of oil and gold and suggested that there is a repeating pattern worth watching. A few quarters back, I said the relationship called for a rising oil price, that \$100 oil was coming our way. Well, it did, and then softened a bit in the face of European woes. But \$100 oil is back.

The relationship now suggests we will see \$120 oil in the months ahead. Again, the rising price relates to Middle East instability, increased scarcity in the face of rising world demand, and inflation. Here are the data. Remember: Since 2009 the price of oil has tracked the price of gold.



Final thoughts: No man is an island entire of itself.

The evidence suggests the U.S. economy is picking up a bit. But how does the sovereign debt crisis in Europe affect the average American? This question was posed to me last week. In my answer, I attempted to explain that each person in a global market economy is connected and that growing division of labor and specialization tend to magnify the linkages that connect us. If Europe slips into a recession, then the prospects for the average American become a wee bit dimmer. I also noted that I understood that U.S. bank exposure to European sovereign debt was not large, but that there was still significant indirect exposure to a European slowdown.

My point: We are connected. When a major trading partner suffers, we suffer.

English poet John Donne (1572-1631) gave a much better answer some 500 years ago in *For Whom the Bell Tolls*.

No man is an island entire of itself; every man
is a piece of the continent, a part of the main;
if a clod be washed away by the sea, Europe
is the less, as well as if a promontory were, as
well as a manor of thy friends or of thine
own were; any man's death diminishes me,
because I am involved in mankind.
And therefore never send to know for whom
the bell tolls; it tolls for thee.



Donne, of course, was reflecting on lost life. I was thinking about lost opportunities. But the point is the same. We are connected in profound ways. And prosperity enhances life and life expectancy.